THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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Thanks for waiting
Nashula

False Profits Revisited

"The only conclusion that really follows is that the credit machine is so designed as to serve the improvement of the productive apparatus and to punish any other use."

Business Cycles
Joseph Schumpeter, 1939

For once, a display of egregious monetary laxity by the Federal Reserve has failed to trigger the customary bullish stampede on Wall Street. While the Fed's decision to leave short-term interest rates unchanged at its September meeting prompted at least a modest cheer from the bond market, U.S. stock investors have other worries, not least of which is the increasingly dubious outlook for corporate profits.

In this issue, we take a another, closer look at the profits picture, which we discussed in some detail in our August and September letters. Our conclusions are even more dismal now than they were then. Stripped of the powerful but transient effects of declining interest rates, the U.S. profits performance in the 1990s has been the worst ever. This reality, masked until recently by Wall Street's bullish fantasies, now threatens to pierce the stock market bubble, with devastating consequences for the overleveraged U.S. economy.

How can we be so pessimistic about the profits outlook, given the 60% rise in corporate earnings since 1991? Surely, this proves the ruthless efforts of U.S. management to cut costs and boost productivity are bearing rich fruit for shareholders, if not for workers?

Unfortunately, it proves nothing of the kind. The restructuring craze notwithstanding, annual U.S. productivity growth remains mired in the 1% range. Our careful review of the evidence shows where credit for the profits miracle rightfully should be placed: with the Greenspan Fed, which has greatly eased the debt-service burdens of U.S. corporations with its ultra-easy monetary policy.

The near collapse of U.S. business fixed investment in the late 1980s and early 1990s also made an important contribution to the earnings boom, by slashing corporate depreciation charges. This, of course, amounted to a form of self-liquidation by Corporate America, but the short-term result was an additional profits windfall.

But, just as drugs may conceal a serious illness without curing it, the illusionary profits recovery of the 1990s did nothing to remove the underlying cancer eating away at the American economy: feeble productivity growth caused by chronic overconsumption and underinvestment. The secular, as opposed to the cyclical, trend in U.S. profits continues to point downward, with no end in sight.

More to the point, the short-term forces that boosted profits in recent years are nearly played out. While Fed inaction may keep rates from rising, that will not be enough to head off a collapse in profit growth. Only a continuing decline in interest rates can prolong the double-digit gains in earnings to which Wall Street has grown accustomed. That simply isn't in the cards. Indeed, without massive support for the dollar from foreign central banks, the Fed would have little choice but to raise rates sharply, with catastrophic consequences for profits.

At best, Wall Street can expect future profits to grow roughly in line with nominal GDP. We seriously doubt whether such meager 4% or 5% gains will meet the expectations of American investors. Sooner or later, those wildly inflated expectations will have to fall to earth. Stock prices can be expected to follow.

MAXIMUM WEALTH WITH MINIMUM SAVINGS

In recent letters, we have addressed two subjects of overriding importance. One, featured in our August letter, concerns the origins of the allegedly peerless U.S. profits boom of the 1990s. The other, highlighted in our September letter, is the equally staggering U.S. wealth creation during the same period.

As the noted U.S. economist Henry Kaufman recently pointed out: "Since the cyclical trough in March 1991, the financial net worth of the American public has mushroomed by over $5,500 billion ... the equivalent of the total amount of new savings which American households accumulated over the preceding 25 years."

In percentage terms, this is a gain of more than 50% in barely five years. Yet this fabulous wealth creation compares with total personal savings out of current income during the period of barely $1 trillion. In other words, for each dollar added to savings, $5.50 was added to personal wealth.

Just as an aside, this steep overall growth in the volume and value of personal net financial wealth has concealed dramatic changes in the composition of U.S. asset holdings. The big relative decline has been in bank deposits and money funds – the liquid reserves of U.S. households. These have increased in absolute terms by just 10%, and have fallen as a share of total assets from 29% to 19%. Of equal importance, about 40% of U.S. personal financial wealth now is held in private and public pension funds and life-insurance reserves.

To be sure, this is a fabulous performance in wealth creation. But, as we pointed out in our last letter, this deluge of new financial wealth compares grotesquely with a bare trickle of real fixed capital formation, not only in the United States but worldwide. It used to be a truism that only the actual means of production can be considered as capital. Securitized government and consumer debts most definitely cannot. They merely are outstanding claims on the future income of particular debtors.

Actually, some older economists label such debts "imaginary capital," on the grounds that they are not backed by any tangible assets. Still others denounced them as "dead-weight" debts – incurred in consequence of spending which in no way adds to the productive power of the community, yielding neither revenue nor services. Of course, one label is the flip side of the other. Borrowers' dead-weight debt becomes investors' imaginary capital.

Obviously, all consumer and most government debt fits into these "imaginary" and "dead-weight" categories. But a growing share of corporate debt also qualifies, given that most corporate borrowing nowadays finances mergers and acquisitions, not fixed investment. It, too, has been rendered barren.

For the most part, real capital spending by corporations in the industrial countries now is confined to what can be financed out of available current cash flow. More often than not, corporations run cash surpluses, which they then invest in financial assets – in other words, in the deadweight debts of governments and consumers. In most countries, the building sector remains the sole net borrower in the private economy. Crowding out – the relentless substitution of government debt for productive investment – is taking place with a vengeance all around the world.

In short, the decisive criterion for true wealth or capital formation is whether the proceeds of any given loan are used to finance new productive plant. But by a rough guess, we would estimate that in the industrial countries currently about 95% or more of all current debt (i.e. financial wealth) is dead weight.

In the last analysis, this is a zero-sum game for the world's real economies. While the communist countries have rid themselves of communism, the capitalist world is busy divesting itself of capital. The frightful long-term consequences of this remarkable historical development will be addressed later in this letter.

In the United States, even the stock market has ceased to serve as a source of real capital formation. Since the early 1980s, corporate stock purchases in the wake of mergers and stock buy-back announcements persistently have exceeded the issuance of new stock. More to the point, we would say the U.S. stock market has been perverted into

an instrument of corporate decapitalization. The only thing that counts now is boosting share values, not new investment and capital formation.

In a balanced economy, devoid of any kind of inflationary distortions, additions to personal wealth are limited to increases in personal savings plus or minus typically moderate changes in the market value of acquired assets. The counterparts to savings are real investments, residential and nonresidential. Wealth creation consists of real capital formation. For all intents and purposes, this was precisely the state of affairs in the world until the outbreak of World War I. That wealth creation of this kind proceeds relatively slowly should be obvious.

Yet as we pointed out, U.S. wealth creation in the 1990s has outpaced the flow of savings fivefold. To be sure, that's wonderful financial magic. Still, there is every reason to inquire into the origins of this magic. Denizens of Wall Street, no doubt, won't hesitate to attribute it to their own efficiency. In a way, they are correct. Wall Street's propaganda machine has played a crucial role in driving people out of their money balances and into securities. This, in turn, has played a large role in fueling the financial boom and the capital gains associated with it.

Yet ultimately, such a divergence between savings and wealth can be created by only one magic wand: loose monetary policy. This has been provided throughout the 1990s by the Greenspan Fed, and by the foreign central banks who prop up the dollar, shielding the Fed from the external restraint that otherwise would be imposed on it by the enormous U.S. balance-of-payments deficit.

WHAT IS INFLATION?

Talking with American officials and (most) American economists about inflation is, frankly speaking, a frustrating exercise. Most focus solely on the price indexes for goods and services as the ultimate measure of inflation. If these indexes are well-behaved, nothing else matters. Neither zooming asset prices, nor a yawning balance-of-payments deficit, nor excessive money and credit flows are taken into account.

In the European economic tradition, inflation traditionally has been defined with reference to its regular cause: an undue expansion of money and credit. But in America, this definition has shifted over time to a radically different meaning. Gradually, inflation has come to be defined solely as a sustained rise in goods and services prices.

Rising prices and an undue monetary expansion obviously are not the same thing. The first phenominon is one of the symptoms of inflation; the other is its usual underlying cause. This difference in definition and concept is more than a matter of semantics. As the recent, prolonged bickering about the need for a Fed rate hike indicates, this question of definition has most important policy implications.

For some time, the chief argument against even a modest Fed rate hike has been that current low U.S. inflation rates don't justify it. What's more, a low inflation rate is viewed widely as a kind of certificate of good health for the economy as a whole. The result is a complete blindness to the signs of rampant inflation that can be seen in the soaring U.S. balance-of-payments deficit and in the overheated financial markets.

When we refer to the European economists and their thinking on inflation, we should stress that we are speaking of the leading figures who dominated the period from the 1920s to the 1950s, thinkers such as Mises, Hayek, Röpke and Robertson, not the number crunchers of today. The common starting point for all of them was to apply the word "inflation" to its *root* cause: undue money and credit growth.

THE KEY DISTINCTION IN MONEY FLOWS

These economists realized that inflation in the sense of an undue expansion of money and credit can have very different effects on an economy and its price system, depending on who the main borrowers are and what they spend the excess money on. They understood that consumer- and producer-price inflation is just one possible outcome. The alternative effects of inflation are rising asset prices and/or a deteriorating balance of payments.

In the same vein, the old European economists had a clear and definite concept of how to identify inflationary finance. In this specific area, the British economists of the so-called Cambridge School (i.e. Marshall, Robertson, Hawtry etc.) led the way.

Crucial to their conception was a strict distinction between two sources of investible funds: flows from "savings out of current income," and flows from a "speculative, inflationary supplement" accruing from either a rise in the money supply or an increase in monetary velocity. Principally speaking, flows in excess of available current savings must be counted as inflationary, for they inevitably distort the equilibrium rate of interest.

But how has this virtual flood of money streaming into the U.S. financial markets in the 1990s actually come about? Paradoxically, it has happened even though America has had its most sluggish money growth for decades during this period. Normally, this would suggest monetary restraint.

Not this time. The unusual monetary sluggishness that has marked the 1990s in the United States has had absolutely nothing to do with credit restraint. To the contrary, there has been a borrowing-and-lending binge. The salient point to understand about the impact of this credit boom on the money supply is that it has been fueled primarily by the capital markets and by nonbank institutions, not by the banking system. In a word: securitization.

In contrast to bank lending, credit creation in the financial markets and in the nonbank sector adds nothing to the existing money supply. Rather, it raises money velocity. In practice, this means that lenders and borrowers use existing money balances in their credit transactions, not newly created bank money.

But this drastic shift in lending activity away from the banks and towards the capital markets and nonbank financial institutions has not been the only reason for the widening gulf between weak money growth and surging money flows. A second cause has been the "cash-is-trash" mentality generated by the prolonged existence of rock-bottom short-term interest rates, which has led to a mass exodus of investors out of bank deposits and into bonds and stocks. This switch is conventionally described as a sharp decline in the demand for money, or, to use the Keynesian phrase, as a downward shift in liquidity preference.

Some time ago, there was a good deal of wrangling between economists about the question of whether the world economy was suffering from a savings or capital shortage. Overwhelmingly those who warned of such a shortage were ridiculed. To us, the arguments advanced against the idea only confirmed what we knew all along: The great majority of people, even economists, now working in the financial markets don't have the faintest clue as to what constitutes the essence of savings.

By definition, savings are the part of current income that is not consumed. In the United States in recent years, this fraction has amounted to between $200 and $250 billion annually. If the flow of funds into the financial markets truly had been confined to this pool of available current savings, U.S. interest rates would be closer to 10% and the Dow perhaps would be lingering around 2,000. But actual money flows into the U.S. financial markets now exceed $1 trillion a year, grossly dwarfing the paltry supply of savings.

BROKERS REPLACE SAVINGS

The fact of the matter is that the multilayered U.S. financial system is capable of creating money flows virtually *ad libitum.* The system has decoupled completely from the supply of available savings. Broker call loans were the main leverage machine leading to the 1929 stock-market collapse. But the far bigger leverage vehicles today are the derivatives markets and the repo and Eurodollar short-term money markets. With them, the amount of market leverage is practically unlimited – and uncontrollable.

It is by no means a joke when we say that the shortage of savings in the United States has been more than compensated for by the overabundant growth of the brokerage industry. According to the latest, improved estimates of the gross product of the various business sectors, U.S. real GDP rose at an average annual rate of 2.3% between

1987 and 1994. Within this total, the manufacturing sector grew at a modest 1.6% rate. The outstanding star performers were commodities and securities brokers. The gross output of the brokerage industry rose at a staggering 10.5% annual rate. In 1994, by the way, more than two-fifths of U.S. GDP came from finance and wholesale and retail trade.

Two other facts about the structural changes in the U.S. economy stand out in these recently published statistics. From 1959 to 1994, the GDP share of private, service-producing industries ballooned from 48.8% of GDP to 62%. The share accounted for by goods-producing industries declined from 38.8% to just 24.2% The big loser in this latter group was manufacturing, whose share fell from 27.7% to 17.3%.

This declining share of manufacturing goes a long way toward explaining some of the U.S. economy's conspicuous peculiarities, both good and bad. The negative aspects are the chronic, huge U.S. trade deficit and persistently poor U.S. productivity growth. On the positive side, the shrinkage of the manufacturing sector probably has diminished the U.S. economy's cyclicality.

LOOKING FOR THE BUYERS

In trying to assess the prospects for the financial markets, our principal approach always has been to focus on the potential sources of demand. As already mentioned, real current savings have become rare specimens in the U.S. credit markets. Both the global bond markets and the U.S. stock market today are dominated by operators who overwhelmingly use borrowed money. In the case of the bond markets, this above all else means the dealers and hedge funds who finance their bond purchases in the repo or Eurodollar markets, usually with leverage ratios of 40- or even 50-to-1.

As for the U.S. stock market, it has an entirely different supply-and-demand structure – one that is unique among the stock markets of the world. There is a widespread perception that the U.S. public's frenzied love affair with stock mutual funds has been the driving force in the bull market. No doubt, it has exerted a crucial influence. But viewing mutual-fund flows in isolation creates a very distorted picture.

Actually, mutual-fund flows, while huge, are topped by two other strong but opposing flows: heavy direct sales by private investors, and massive corporate purchases of outstanding stock. Particularly in 1994-95, corporations turned into big net buyers of equities, as their purchases through buy backs, mergers and acquisitions far outpaced new public offerings. Logically, this implies that the financial community – both private and institutional investors – must have been net sellers of equities by a corresponding amount. Seen in this light, it definitely is misguided to regard the mutual fund mania as the chief creator of the bull market.

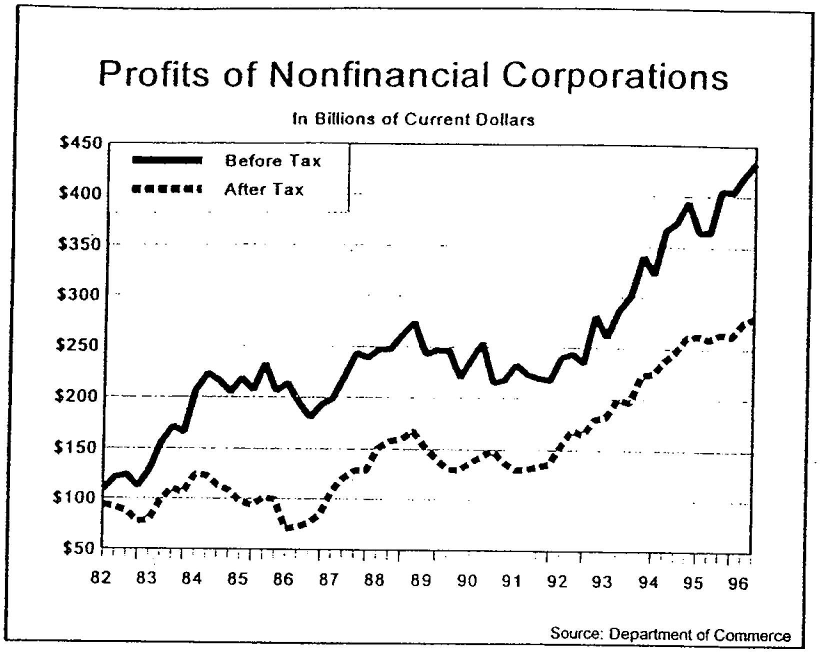
Of course, it can be argued that on the margin, stock mutual funds exerted the decisive bullish influence. But this still doesn't give us a true insight into the prevailing market forces. Rather, it conceals more than it reveals. An unbiased analysis would stress the critical role of corporate stock buying, particularly in view of its anomalous character. Yet it gets little or no publicity.

THE GREATEST THREAT TO STOCK PRICES: PROFITS

After twisting and flailing through the summer months, including a white-knuckle drop in July, U.S. stock prices suddenly took off again in late August. If there was any reasonable explanation for this new burst of stock buying, it seemingly was a spate of good news about inflation and growth, which helped dispel the looming fears of an impending rate hike by the Fed.

Despite this latest buying binge, it is widely realized in the markets that the corporate earnings boom of the 1990s has peaked. Yet, since no dramatic deterioration is expected, nobody seems to care. As one commentator recently put it: "U.S. equity markets remain boxed in between stronger growth, with stronger earnings but higher interest rates, or weaker growth, with lower interest rates but weaker earnings." In other words: Stocks can't lose no matter what happens to the U.S. economy.

There have been a rash of profit warnings in recent weeks. However, rather than take note of the bad news coming out of corporate America, the stock market has preferred to focus on the scattered pieces of good news. An announcement by Intel, the semiconductor manufacturer, that earnings had turned out better than previously feared proved enough to drive up the share prices of technology companies – drowning out the dire profit warnings issued by most of those firms.

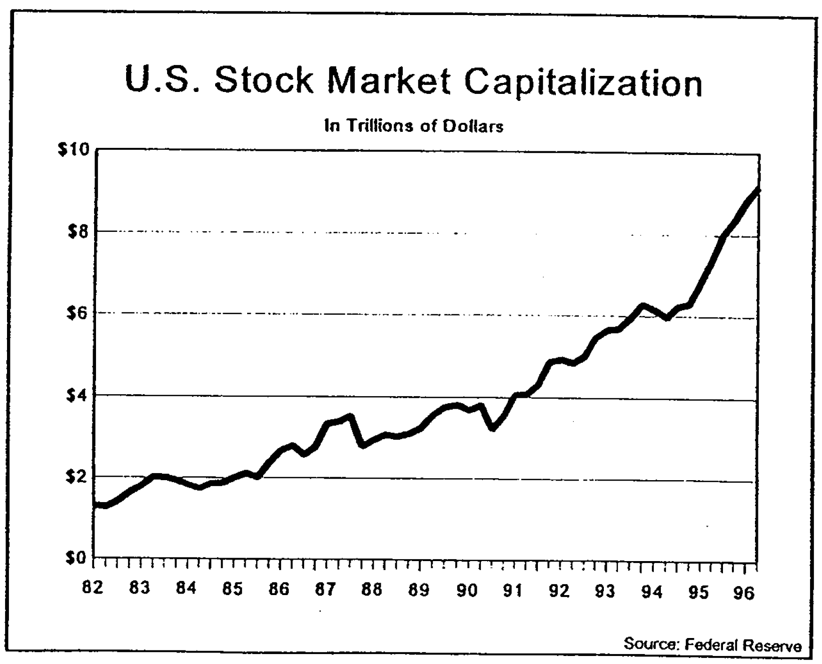


It has long been our conviction, repeatedly expressed in this letter, that the Greenspan Fed will never dare submit the U.S. economy and financial markets to any serious monetary tightening. Symbolic flea-sized hikes, perhaps, although right now the Fed is shying away from even minor tightening measures. But moves that could really hurt, never. In our view, considerably higher consumer and producer inflation rates are not in the cards. By focusing narrowly on these price indicators, the Fed conveniently can ignore all the other existing U.S. economic imbalances.

Assuming that money remains permanently loose, what might stop the bull market? Our answer: collapsing profits growth. That's not just guesswork, but the definite conclusion we have derived from our thorough analysis of the underlying influences that fueled the U.S. profits boom in the 1990s. The crucial point to grasp is that these special, one-time effects have exhausted themselves.

A COMBINED PROFIT AND VALUATION BOOM

We highlighted this looming profits debacle in our last two letters. But the muddled comments we have seen elsewhere on this topic, and its overriding importance, compel us to elaborate further here. However, to understand the future, it is necessary first to understand the past. Let us review, briefly, how the roaring bull market in U.S. stocks during the 1990s came about.



On closer examination, it can be seen that stock prices in the 1990s have been propelled by two primary influences, both of which exerted unusual leverage in the market. One was the extraordinary profits boom, the other an extraordinary rise in the valuation of those profits.

In this respect, two things instantly catch the eye. One is the steep rise in profits after 1991, when the current cyclical upswing began. The other is the even steeper rise in the market valuation of stock prices.

Over the entire period, profits before tax surged by 60%, or at an average annual rate of 15%. After-tax profits grew by 57.9%, or at a 14.5% annual rate. Measured against nominal GDP growth of 27.5% in this period, it was a stellar performance.

No less impressive was the generosity with which the stock market evaluated this performance. The Dow Jones Industrial Average soared by 96% during 1991-96 period; the S&P 500 rose 82%, and the Nasdaq leaped 106%. All told, the market capitalization of the U.S. stock market rose by no less than 89%, from $4.9 trillion to $9.2 trillion. It was a combined profits and valuation boom.

What next for profits? That, of course, is the key question to be investigated in trying to make any forecast for the stock market, considering that by most valuation measures U.S. stocks already are heavily overpriced.

THE INEVITABLE COLLAPSE OF PROFITS GROWTH

According to the Wall Street pundits, the profits boom of the 1990s is the fruit of corporate striving for greater efficiency in a world of weaker growth. To quote a recent report from one leading broker: "We continue to view current developments as confirmation that there has been a secular change in U.S. productivity."

We have never been taken in by these stories, which contrast flagrantly with official data showing continued dismal U.S. productivity growth. On the other hand, we do see plainly the true sources of Wall Street's profits boom. They are very different from those outlined in the productivity myth. As we have stressed in past letters, they involve easy windfall gains rather than hard-won productivity gains. Of these profits sources, four predominate:

- The steep, secular decline in U.S. interest rates.
- Sluggish growth in corporate depreciation charges.
- Persistent dollar depreciation, bolstering profits from foreign operations expressed in dollar terms.
- A shift in the funding of corporate pension plans from cash contributions at the expense of earnings to capital gains on pension-fund assets to the benefit of earnings. Thanks to the stock-market boom, payments to pension beneficiaries have become virtually a free lunch for Corporate America.

Realizing that the profits question rapidly is becoming the hottest issue for the U.S. stock market, we addressed the theme in our August letter. There we presented proof in hard figures that the miraculous profit crescendo in the 1990s stemmed primarily from the first of our windfall factors listed above: the steep decline in interest rates engineered by Alan Greenspan and the Greenspan Fed.

So far, the brokerage community is blissfully oblivious to this profits distortion. Despite multiplying earnings disappointments, Wall Street's overall forecasts continue to assume an ongoing profits boom, though at a somewhat slower rate than in the recent past. The basic, underlying assumption is that the profit upsurge of recent years mainly reflected the widely heralded efficiency miracles wrought by corporate downsizing and restructuring, and that both miracles will continue indefinitely.

In truth, these alleged efficiency gains find no confirmation whatsoever in the U.S. income and product accounts. Recorded productivity growth is proceeding at its familiar dismal rate of less than 1% per annum. Yet Wall Street remains in persistent denial of this fact. It flies too much in the face of its bullish stories.

Against this view, we have argued our case that the excellent profits performance of U.S. corporations in the 1990s had nothing to do with efficiency gains, but rather had everything to do with windfall gains from falling interest costs. But we have come to realize something even more shocking: The corporate profits performance of recent years, adjusted for lower tax rates and falling net-interest costs, actually has been the worst of the entire post-war period. Corrected for those two special factors, U.S. corporate-profit margins are far below historical levels. Not

only has business efficiency failed to improve, it actually has worsened.

We have to admit, when our calculations revealed this profits fiasco we at first couldn't believe our eyes. Though expecting pretty poor results, we were not quite prepared for the disastrous picture that actually emerged. Therefore, we find it reassuring that *The Bank Credit Analyst*, a widely respected publication, has fully confirmed our findings with its own elaborate calculations.

The true picture is illustrated in the charts shown here, adapted from *The Bank Credit Analyst*'s September issue. They show the expansion in U.S. corporate-profit margins during the existing expansion compared to the four previous business cycles, not including the aborted recovery of 1980-81.

As can be seen, the profits performance in the current cycle seems to shine brightly – until interest costs and taxes are taken into account. On a pretax, pre-interest basis, however, profits continue to lag the historical trend, a full 22 quarters into the current expansion.

Why should it be such a disaster that the U.S. profits boom of the 1990s accrued solely from lower tax and interest costs? In short, because both these factors are one-off, temporary influences. And what's more, both have run their course.

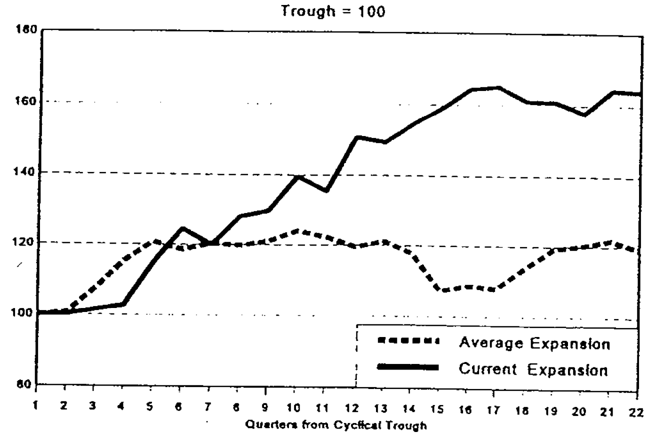
Together, this suggests that for U.S. business the moment of truth at long last has arrived. In this particular case, the moment of truth means the overriding dependence of future earnings growth on real productivity gains. But, as we previously noted, U.S. productivity growth now is a very poor source of income and profits.

The Profits Mirage

Change in profit margins of U.S. nonfinancial corporations. Current expansion versus average of four previous expansions (1980-81 not included).

Profits After Net Interest and Tax

Trough = 100



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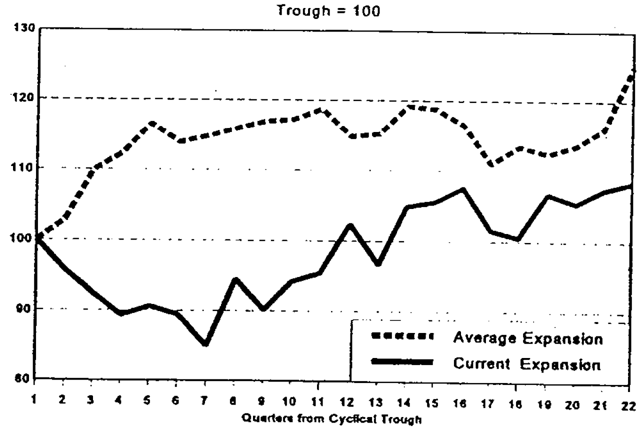

Source: Department of Commerce

THE KEY FALLACY IN WALL STREET'S BULLISH CASE

As we mentioned, for Wall Street it always has been a foregone conclusion that the 1990s profits boom was rooted in extraordinary efficiency gains from corporate downsizing and restructuring, which has bolstered the profits share of national income by squeezing the labor share.

A recently published study by Goldman Sachs on this subject explicitly confirms this assumption, arguing that this big income shift from labor to business is nothing temporary but rather of a lasting nature. The explanation

offered for this theory is that the earnings surge underlying the Wall Street boom merely reflected a recovery of the U.S. profits share from the overly depressed levels of the early 1980s to basically normal levels today.

We mention this report and its conclusions because it leads us straight to the key fallacy in Wall Street's bull case. At the root of this error is the difference between a high *absolute* profits share of national income and a rising *trend* in the size of that share. If the profits share stops rising, a stable share, no matter how high, implies long-term profit growth in line with nominal GDP and national income growth. In the United States, this translates into a modest annual growth rate of about 5%.

Five percent future profits growth versus the lofty 15% annual increases seen in recent years! Will that affect the stock market? Unquestionably, it will. An economic slowdown, which we think can be expected soon, would only add to the market's profits troubles. To be sure, this is a shocking prospect for Wall Street. Once it sinks in, the stock market certainly will be hammered.

There is another critical question that needs to be asked: Why hasn't business profitability done better? *The Bank Credit Analyst*, equally puzzled, concludes that companies have been leaning hard against a powerful deflationary head wind. An increasingly competitive environment has restricted corporate pricing power. This has made aggressive cost cutting a requirement for survival, not an easy route to higher margins.

U.S. BUSINESS PROFITS DEPEND ON INFLATION

Though this seems a rather benign explanation, we actually find it quite frightening, raising as it does the next question: Where does all this lead? For us, the outlook is far from benign, as we have explained in past letters. At the heart of America's economic problems is not deflation or disinflation, but rather measly productivity growth.

Real U.S. wages essentially are stagnant, with annual wage hikes barely matching the 2.5% to 3% rise in the Consumer Price Index. Yet, compared to feeble annual productivity growth of less than 1%, these wage gains are very high. The salient point to see is that in the absence of higher productivity growth, business profits depend crucially on a sustained 3% annual inflation rate. Mr. Greenspan and his Fed obviously are perfectly willing, even eager, to deliver this. But in attempting to do so, they are getting increasingly caught in the financial bubble on Wall Street. This is the Damocles Sword hanging over their heads. Eventually, it will fall.

But returning to our basic question: How can the U.S. stock-market bubble ever burst, if Mr. Greenspan persists in his loose monetary stance? For some time now our view been that to answer this question, one must identify the forces behind the financial boom.

Earlier, we said there have been two main engines driving the boom: soaring profits on the one hand, and soaring valuation ratios on the other. But importantly, both motors have had one and the same chief propellant: plunging interest rates. Falling rates raise the operating earnings of businesses by reducing their debt-service costs. At the same time, they tend to boost the valuation ratios assigned to those earnings, because long-term interest rates are the yardstick for capitalizing the yields on illiquid assets such as equities.

Accordingly, the outlook for interest rates, both short and long, is crucial to our assessment of the stock-market situation. In our view, from present interest-rate levels there is very little room left on the down side. What is not widely understood, apparently, is the fact that a mere bottoming of rates, even at low levels, is enough to completely blunt their leverage effect on profits and valuations. As we remarked earlier with regard to the profits share of national income, what is decisive is the trend, not the absolute level of rates.

IS THIS ECONOMIC HEALTH?

As for the U.S. economy, we abide by our view that the prospect is for a deceleration, not an acceleration in growth, despite the Fed's loose-money policies. In conventional thinking, the U.S. economy is surprisingly strong, We, on the other hand, see unsustainable consumer borrowing financing unsustainable consumer spending, breeding

big problems for the near future. Indeed, comparing the rampant increase in short-term consumer debt with total spending for goods, services and particularly for financial assets, we are forced to the chilling conclusion that U.S. households essentially are buying stock mutual funds with their credit cards.

Since 1992, American consumers have matched income growth of roughly $1.2 billion with an equal amount of debt growth. Through borrowing, they have doubled their purchasing power. If we marvel about the financial recklessness of the consumer, we must marvel even more at the way U.S. policymakers and economists hail this expansion – the result of so much debt and consumption growth – as proof of America's long-term economic health.

The real story here is the incredible buildup of the financial infrastructure for financing both consumer borrowing and leveraged speculation. As short-term interest rates have plunged and yield curves have widened, lending activity outside of the banking system has mushroomed. Importantly, the benchmark interest rate for this exploding market is the low federal funds rate, not the considerably higher bank prime rate. Another facet of this shift in financing from banks to the money and capital markets is the tremendous distortion in money growth stemming from the fact that all of this non-bank lending is simply recycling the existing money stock.

Imagine what would happen to this huge edifice of credit if the yield curve inverted, as it regularly has done in past business cycles. It would collapse like a house of cards. Mr. Greenspan cannot and will not allow this to happen. The Fed's myopic focus on consumer-price inflation will provide the rationalization it needs to hold rates low. We expect that particular form of inflation to remain subdued, as excess U.S. demand spills over into imports.

But the lurking dangers to the U.S. economy are not limited to the world of finance. Prolonged, massive overborrowing for consumption inevitably has led to an overexpansion in consumer services and distribution. Shopping malls, department stores, retailers of every size and description, restaurants, casinos, hotels, etc. etc. – all continue to spread like weeds across the American economic landscape, fertilized by the consumer-borrowing binge. This, too, is an investment boom of sorts, though in reality a *malinvestment* boom. Meanwhile, the emerging market economies of Asia have staked their economic future heavily on exporting to the bloated U.S. retailing sector.

Looking at the zigzags in the U.S. economic data, we feel little inclination to compete with the numbers crunchers desperately trying to auger the future – meaning next quarter's GDP growth – from the statistical entrails. The big plus of the U.S. economy is its flexible labor market and associated employment growth fueling strong income growth. The big negatives are the excesses in consumer borrowing and in the financial markets. In the long run, these spell disaster, but exactly when disaster will arrive is impossible to say. Normally, the day of reckoning would be signaled by a currency crisis, but in the dollar's case, this is forestalled by the foreign central banks.

Given that a deceleration, rather than an acceleration of the U.S. economy is likely, loose money would seem assured for as far as the eye can see. Accordingly, the one certain near-term threat we see for the U.S. stock market is the imminent sharp slowdown in profits growth. A pricking of the stock-market bubble undoubtedly would prick the consumer-borrowing bubble by deflating the balance sheets of U.S. households.

THE MYSTERIOUS DISINFLATION

Worldwide, we also see nothing but loose money ahead. Unfortunately, the root cause of this laxity is anything but benign. Protracted subpar economic growth, we think, should continue to suppress inflation in the price indexes. The conventional explanations for this trend are increased global competition, and a mysterious disinflationary trend that nobody seems to be able to explain, given the rampant global credit expansion.

In truth, the world credit supply generally is overabundant. The trouble is that this credit bonanza is having progressively diminishing effects on economic growth. In the United States, nominal GDP growth of $994 billion since 1993 has been accompanied by nonfinancial debt growth of $1,738 billion. That is, for each dollar added to GDP, $1.75 has been added to debt. These figures don't include most of the vast borrowing for financial speculation. To label such a scenario as disinflation reveals a complete lack of understanding of what really is going on.

It is useful to remember what used to be considered normal. We are thinking here of the period before World War I, and the heyday of the Bretton Woods system in the 1950s and 1960s. Then, as today, private households

were the principal surplus sector that provided savings to the deficit sectors – those that spent more than their current income. In those times, government budget deficits were small or nonexistent. The big borrowers were the business and construction sectors, who used the savings of private households to finance investment spending. Virtually everywhere, those were times of low inflation, low interest rates and rapid economic growth.

But since the early 1970s, this pattern has progressively and radically changed. Government spending and borrowing have exploded, while business borrowing for investment and building has retreated sharply. In some countries, particularly the United States, consumer borrowing has rocketed along with government borrowing, while private savings have plummeted. While the scope of these trends has varied from country to country, the general results are well known: surging debt levels, higher inflation and interest rates, and sharply slower economic growth. Clearly, debt growth has had a diminishing effect on economic growth, even as it has had a rising effect on inflation and interest rates. This profound decline in growth has had two main reasons: a change in the use of borrowed money, and the long-term effect of this change on income growth.

All spending evokes further spending and income creation by those who receive the money spent. Conventionally, this is referred to as the multiplier effect. But depending on the expenditure, this effect can vary enormously. Construction traditionally has had the highest multiplier. At the opposite extreme are interest-rate payments, which largely end up in the coffers of institutional or private investors who have a low propensity to spend on goods and services, but a high propensity to spend on existing assets, such as stock and bonds. Income circulation is shifted into financial circulation. The result: zero income growth and a zero multiplier effect.

Without going into more detail, we can generalize that government spending of many different kinds – wages, transfer payments, interest expense, etc. – has much lower multiplier effects than investment spending on building and equipment. That's one reason why government spending can never be a substitute for investment spending.

THE VICIOUS CIRCLE OF UNPRODUCTIVE DEBT

Rather more important is the second issue: the long-term income effects of this shift in debt use. Government and consumer borrowing have only short-run demand effects. But the debt-service burdens that result from such borrowing cut progressively into incomes. By contrast, debt-financed investment spending adds to supply and thus to incomes. Normally, this income growth is sufficient to cover future debt-service costs. In short, productive debt delivers self-financing economic growth. Government and consumer borrowing for current consumption does not.

That's why heavy government and consumer borrowing essentially sets a vicious circle in motion. To avoid any income contraction from rising debt-service costs, borrowers must repay debt with more debt, progressively adding to their borrowing needs. Over time, it becomes a race between ever-higher interest bills and ever-faster debt growth. One thing above all makes it a hopeless race for the debtor right from the start: compounding interest. At a 7% interest rate, a debt virtually doubles within ten years. At 11%, it doubles within six years. The ancient Greeks already knew these dire facts. Plutarch, in his *Moralia*, speaks of "interest rolling on interest, as wave on wave."

What American policymakers and economists have yet to learn, apparently, is that in this respect consumer debt is no different from government debt. Both are "dead weight" debt. The only difference is that governments can raise taxes to meet their rising interest bills. Looking at the ongoing consumer borrowing binge in the United States, we would think a central bank that cared about the long-term stability of its economy long ago would have acted to restrain such excesses. But serious restraint inevitably would prick the Fed's beloved financial bubble. By holding interest rates artificially low, the Fed has succeeded in prolonging the borrowing binge by slowing the buildup of debt-service costs. Nevertheless, this is a policy that inexorably courts disaster in the long run.

THE GREAT EURO FUDGE

In our last letter, we stated that growing doubts about compliance with the fiscal criteria for European Monetary Union were working in favor of the DM and the Swiss franc. We also explained that the dollar's weakness was the long-term result of the Fed's insistent monetary looseness. Shortly afterwards, the dollar promptly rose.

Of course, the fundamentals have not changed a bit. Oddly, the dollar's recovery started instantly after the Fed's August decision to keep rates unchanged – a decision reaffirmed by the Fed last month. In reality, the dollar rose

on DM weakness across the board. The reason? Various events and declarations suddenly have turned the former mood of Euro skepticism into a renewed optimism. This triggered a rush into Europe's high-yielding currencies, mainly the Italian lira and the Spanish peseta, on news that the governments of those two countries are taking drastic steps to cut their budget deficits next year to 3% of GDP, the qualification target for EMU. As shown in past speculative episodes, such cross trading out of the DM and into other European currencies tends to lift the dollar.

The second major event aiding the dollar was a cut in the Swiss discount rate of a half a percentage point, to 1%. While the Fed's inaction was ignored, the Swiss move was interpreted happily as a sign that interest rates in Europe, in particular German rates, are headed lower still. This also boosted European bond and stock markets.

Among the major measures announced by the Italian government is a so-called "Europa" or "Maastricht" income tax to be imposed only for 1997 – the decisive year for meeting the EMU criteria. We would say such a one-year tax rise is a flagrant fudge that makes a mockery of the entire assessment process.

Of equal calibre is the accounting trick concocted by the French government. It has decided to include in its 1997 budget a one-off payment worth 37.5 billion French francs, or 0.46% of GDP, from French Telecom, in return for which the government will assume the company's pension liabilities. France's public-sector deficit is estimated to run this year at 4.5% of GDP. Realistically, the French government appears completely unable to trim its deficit, as the near-stagnation of the economy is undercutting revenue growth. While unemployment has hit 12.6%, the prospect is for another hot winter of strikes and protests.

EMU is only possible in 1999 if the criteria laid down in the Maastricht Treaty are fudged. Either the targets simply will be overridden, or the deficits reported for 1997 will be shamelessly massaged. That's the evil spirit with which Europe's self-righteous politicians try to forge their united Europe. It definitely is not a Europe of the people.

CONCLUSIONS

On the EMU front, we still believe the ride likely will be a bumpy one, as most countries, in particular France and Italy, are unlikely to satisfy the Maastricht fiscal-deficit criterion. Actually, the hurdles will rise next year, when at long last concerted fiscal tightening will hit the European economy. Remember that Germany and France haven't really tightened their policy until now but will do so next year. For sure, this will give rise to waves of speculation pro and contra the implementation of EMU.

We see looming danger for the U.S. economy – not in a possible overheating but rather in a bursting of the financial bubble and the associated consumer-borrowing binge. But given the Fed's super-loose monetary policy, the timing of this debacle is impossible to predict.

The dollar received its recent upward push from a coincidence of several minor influences that caught the markets off guard. But strong U.S. economic growth would make for a higher current-account deficit, while weaker growth would bring lower interest rates. Either way, the dollar will tend to weaken again.

THE RICHEBÄCHER LETTER

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